Internal Revenue
bulletin

Bulletin No. 1998–44
November 2, 1998

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

T.D. 8786, page 4.

Final regulations under section 863 of the Code govern the source of income from sales of inventory produced in the United States and sold in a possession of the United States or produced in a possession of the United States and sold in the United States and from sales of inventory purchased in a possession of the United States and sold in the United States. Final regulations under section 936 of the Code govern the source of income from sales in the United States of property purchased from a corporation that has an election under section 936 in effect.

EMPLOYEE PLANS

Notice 98–50, page 10.

Roth IRAs; recharacterizations; conversions. This notice sets forth examples and a proposed rule with respect to the recharacterization and reconversion of amounts converted from a traditional IRA to a Roth IRA.

Notice 98–51, page 11.

Weighted average interest rate update. The weighted average interest rate for October 1998 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

EXEMPT ORGANIZATIONS

Announcement 98–98, page 18.

A list is provided of organizations that no longer qualify as organizations for which contributions are deductible under section 170 of the Code.

ADMINISTRATIVE

Announcement 98–95, page 13.

The Service announces a proposed revision to Form 8857, Request for Innocent Spouse Relief (And Allocation of Liability and Equitable Relief) and requests comments on the revision.

Announcement 98–96, page 18.

T.D. 8776, 1998–33 I.R.B. 6, relating to U.S. taxpayers operating, investing, or otherwise conducting business in the currencies of certain European countries that are replacing their national currencies with a single, multinational currency called the euro, is corrected.

Announcement 98–97, page 18.

REG–245256–96, 1998–34 I.R.B. 9, relating to the excise taxes on excess benefit transactions, is corrected.

Finding Lists begin on page 21.
Index for January-October begins on page 23.

Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents of a permanent nature are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis and are published in the first Bulletin of the succeeding semiannual period, respectively.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Section 863.—Special Rules for Determining Source

26 CFR 1.863–3: Allocation and apportionment of income from certain sales of inventory.

T.D. 8786

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Source of Income From Sales of Inventory Partly From Sources Within a Possession of the United States; Also, Source of Income Derived From Certain Purchases From a Corporation Electing Section 936

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 863 governing the source of income from sales of inventory produced in the United States and sold in a possession of the United States or produced in a possession of the United States and sold in the United States; final regulations under section 863 governing the source of income from sales of inventory purchased in a possession of the United States and sold in the United States; and final regulations under section 936 governing the source of income of a taxpayer from the sale in the United States of property purchased from a corporation that has an election under section 936 in effect. This document affects persons who produce (in whole or in part) inventory in the United States and sell in a possession, or produce (in whole or in part) inventory in a possession and sell in the United States, as well as persons who purchase inventory in a possession and sell in the United States, and also persons who sell in the United States property purchased from a corporation that has a section 936 election in effect.

DATES: *Effective Date.* These regulations are effective November 13, 1998.

Applicability Date. These regulations apply to taxable years beginning on or after November 13, 1998.

FOR FURTHER INFORMATION CONTACT: Anne Shelburne, (202) 874-1305 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1556. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated average annual burden per respondent is approximately 2.5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and the **Office of Management and Budget,** Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains final regulations under section 863 of the Internal Revenue Code (Code), providing rules to source income from cross-border sales of certain property, where the property is manufactured in a possession of the United States and sold in the United States, or vice versa, or purchased in a possession and sold in the United States. These regulations also contain rules under section 936 to source income of a taxpayer from the sale in the United States of property purchased from a corporation that has an election under section 936 in effect.

On October 10, 1997, proposed regulations [REG–251985–96] were published in the **Federal Register** (62 F.R. 52953). Having considered the comments, the IRS and the Treasury Department adopt the proposed regulations without significant change in this Treasury decision.

Explanation of Provisions

I. *Income Partly From Sources Within a Possession*

Section 863 authorizes the Secretary to promulgate regulations allocating or apportioning, to sources within or without the United States, all items of gross income, expenses, losses, and deductions other than those items specified in sections 861(a) and 862(a).

Guidance in these regulations to determine the source of possession income under section 863 concerns two types of transactions: transactions described in section 863(b)(2) for property produced in the United States and sold in a possession (or vice versa), and transactions described in section 863(b)(3) for property purchased in a possession and sold in the United States (collectively, Section 863 Possession Sales).

1. Methods for allocating or apportioning gross income from Section 863 Possession Sales

a. Property produced and sold

Under the final regulations, income from sales of inventory produced in the United States and sold in a possession of the United States or produced in a possession and sold in the United States (collectively, Possession Production Sales), is allocated or apportioned according to one of three methods.

Paragraph (f)(2)(i)(A) of the regulations makes the 50/50 method the general rule to allocate gross income from Possession Production Sales between production

activity and business sales activity, so that the income from each type of activity can then be apportioned between U.S. and foreign sources. The taxpayer, however, may elect to apply the independent factory price (IFP) method (described in paragraph (f)(2)(i)(B)), or, with the consent of the District Director, the books and records method (described in paragraph (f)(2)(i)(C)).

Under the possession 50/50 method, the final regulations allocate half of the taxpayer's gross income from Possession Production Sales to production activity and half to business sales activity. The income is then apportioned between U.S. and possession sources based on a property fraction and a business sales activity fraction.

The final regulations apply the property fraction in §1.863–3(c) to apportion the half of a taxpayer's income allocated to production activity. Thus, income is apportioned to the United States or to a possession or to other foreign sources based on the location of the taxpayer's production assets. Consistent with the changes made to the regulations under §1.863–3(c), production assets are defined as tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory sold in Possession Production Sales. Production assets are included in the fraction at their adjusted tax basis, consistent with the changes made to the regulations under §1.863–3(c).

The other half of the taxpayer's gross income, allocated to business sales activity, is apportioned according to a business sales activity fraction. The portion of this income that is possession source income is determined by multiplying the income by a fraction, the numerator being the business sales activity of the taxpayer in the possession, and the denominator being the business sales activity of the taxpayer within the possession and outside the possession. The remaining income is sourced in the United States. Although some of the business sales activity factors not incurred in a possession may be incurred in a foreign country, Treasury and the IRS believe that the business sales activity fraction is only intended to source the business sales activity portion of Possession Production Sales outside the United States to the extent of business sales activity located in a possession.

Under the final regulations, as opposed to the current regulations, business sales activity is measured by the sum of certain expenses, including amounts paid for labor, materials, advertising, and marketing (but excluding any expenses or other amounts that are nondeductible under section 263A, interest, and research and development), plus receipts for the sale of goods. This formula is intended to reflect better the business sales activity producing the income by including more of the factors responsible for producing that income. Also, cost of goods sold is now excluded from the business sales activity fraction apportioning income from Possession Production Sales, because such costs generally reflect production activity. Production activity is already represented in the formula by the one-half of the taxpayer's income apportioned according to the location of production assets.

The final regulations provide explicit guidance for attributing business sales activity between the United States and a possession. In attributing business sales activity between the United States and a possession, expenses are allocated and apportioned between the United States and a possession based on the rules in §§1.861–8 through 1.861–14T. Gross sales are allocated to the United States or a possession based on the place of sale.

The final regulations make the IFP method elective, and thus eliminate any bias against taxpayers choosing to export through independent distributors. The regulations rely upon the regulations under §1.863–3 for rules in applying the IFP method.

The final regulations permit taxpayers to request permission from the District Director to use their books and records to determine the source of their income. The final regulations refer to §1.863-3(b)(3) in applying the method to Possession Production Sales.

b. Property purchased and sold

Paragraph (f)(3)(i)(A) makes the business activity method the general rule to apportion income between the United States and a possession, from sales of property purchased in a possession and sold in the United States (Possession Purchase Sales). The taxpayer may, however, elect to apply, with consent of the District Director, the books and records method.

The final regulations apportion the taxpayer's income from Possession Purchase Sales on the basis of a business activity fraction. The portion of this income that is possession source income is determined by multiplying the income by a fraction, the numerator being the business of the taxpayer in the possession, and the denominator being the business of the taxpayer within the possession and outside the possession. The remaining income is sourced in the United States.

The business activity fraction is similar to the business sales activity fraction discussed previously, used to apportion the taxpayer's income in Possession Production Sales, except that the fraction applies only to expenses, cost of goods sold, and sales attributable to Possession Purchase Sales. In addition, the business activity fraction apportioning Possession Purchase Sales includes amounts paid for cost of goods sold. Such costs are attributed to the possession, however, only to the extent the property purchased is manufactured, produced, grown, or extracted in the possession. Treasury and the Internal Revenue Service anticipate that if a taxpayer acts in the reasonable belief that the products were manufactured in the possession, the taxpayer could act on that basis in preparing its tax return. The business activity fraction reflects the view of Treasury and the IRS that the purchase rule of section 863(b)(3) was intended to apply only to purchase and resale transactions where the goods purchased are created or derived from the possession.

The final regulations permit taxpayers to request permission from the District Director to use their books and records to determine the source of their income. The proposed regulations refer to §1.863–3(b)(3) in applying the method to Possession Purchase Sales.

2. Determination of source of gross income

Under the final regulations, once gross income attributable to production activity, business activity, or sales activity has been determined under one of the prescribed methods, the source of the gross

income is determined separately for each type of income. The source of gross income attributable to production activity (when applying the possession 50/50 method) is determined under paragraph (c)(1), based on the location of production assets. The source of gross income attributable to sales activity (when applying the IFP method or the books and records method) is determined under paragraph (c)(2), based generally on the location of the sale. The source of gross income attributable to business sales activity (when applying the possession 50/50 method) is determined under paragraph (f)(2)(ii)(B), based on expenses and gross sales attributable to Possession Production Sales. The source of gross income attributable to business activity (when applying the business activity method) is determined under paragraph (f)(3)(ii), based on expenses, cost of goods sold, and gross sales attributable to Possession Purchase Sales.

3. Determination of source of taxable income

Once the source of gross income is determined under paragraph (f)(2) or (3), taxpayers then determine the source of taxable income. Under paragraph (f)(4), taxpayers must allocate and apportion under §§1.861–8 through 1.861-–14T the amounts of expenses, losses and other deductions to gross income determined under each of the prescribed methods. In the case of amounts of expenses, losses and other deductions allocated and apportioned to gross income determined under the IFP method or the books and records method, the taxpayer must apply the rules of §§1.861–8 through 1.861–14T to allocate and apportion these amounts between gross income from sources within the United States and within a possession. However, for expenses, losses and other deductions allocated and apportioned to gross income determined under the possessions 50/50 method or gross income from Possession Purchase Sales determined under the business activity method, taxpayers must apportion expenses and other deductions pro rata based on the relative amounts of U.S. and possession source gross income. Nevertheless, the research and experimental (R&E) expense allocation rules in §1.861–17 apply to taxpayers using the 50/50 method, so that the R&E set aside (described in §1.861–17) remains available to such taxpayers.

4. Treatment of gross income derived from certain purchases from a corporation that has an election in effect under section 936

The final regulations clarify that section 863 does not apply to determine the source of a taxpayer's gross income derived from a purchase of inventory from a corporation that has an election in effect under section 936, if the taxpayer's income from sales of that inventory is taken into account to determine benefits under section 936(h)(5)(C) for the section 936 corporation.

5. Treatment of partners and partnerships

The final regulations rely on the rules in §1.863–3(g) for determining the appropriate treatment in transactions involving partnerships. Under those rules, the aggregate approach applies to a partnership's production and sales activity for two purposes only. First, the aggregate approach applies in determining the character of a partner's distributive share of partnership income. Second, the aggregate approach applies in sourcing income from sales of inventory property that is transferred in-kind from or to a partnership.

6. Election and reporting rules

Under paragraph (f)(6)(i) of the final regulations, a taxpayer must use the 50/50 method to determine the source of income from Possession Production Sales unless the taxpayer elects to use the IFP method, or elects the books and records method. For Possession Purchase Sales, a taxpayer must use the business activity method, unless the taxpayer elects the books and records method. The taxpayer makes an election by using the method on its timely filed original tax return. That method must be used in later taxable years unless the Commissioner or his delegate consents to a change. Permission to change methods in later years will be granted unless the change would result in a substantial distortion of the source of income.

A taxpayer must fully explain the methodology used in applying either paragraph (f)(2) or (3), and the amount of income allocated or apportioned to U.S. and foreign sources, in a statement attached to its tax return.

II. *Income Derived From Certain Purchases From a Corporation That Has an Election in Effect Under Section 936*

These regulations clarify that, where a taxpayer purchases a product from a corporation that has an election in effect under section 936, the source of the taxpayer's gross income derived from sales of that product (in whatever form sold) in the United States is U.S. source, if the taxpayer's income from sales of that product is taken into account to determine benefits under section 936(h)(5)(C)(i) for the section 936 corporation. The taxpayer's income is U.S. source without regard to whether a possession product is a component, end-product form, or integrated product. No inference should be drawn concerning the treatment of transactions involving sales of property purchased from a section 936 corporation entered into before the regulations are applicable.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the rules of this section principally impact large multinationals who pay foreign taxes on substantial foreign operations and therefore the rules will impact very few small entities. Moreover, in those few instances where the rules of this section impact small entities, the economic impact on such entities is not likely to be significant. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Anne Shelburne, Office of Associ-

ate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for "Section 1.863–3", removing the entry for "Sections 1.936–4 through 1.936–7" and adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.863–3 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h).***

Section 1.936–4 also issued under 26 U.S.C. 936(h).

Section 1.936–5 also issued under 26 U.S.C. 936(h).

Section 1.936–6 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h).

Section 1.936–7 also issued under 26 U.S.C. 936(h).***

Par. 2 Section 1.863–3 is amended as follows:

1. Paragraph (f) is revised.

2. Paragraph (h) is amended by adding a sentence at the end of the paragraph.

The revision and addition read as follows:

§1.863–3 Allocation and apportionment of income from certain sales of inventory.

* * * * *

(f) *Income partly from sources within a possession of the United States*—(1) *In general.* This paragraph (f) relates to gains, profits, and income, which are treated as derived partly from sources within the United States and partly from sources within a possession of the United States (Section 863 Possession Sales). This paragraph (f) applies to determine the source of income derived from the sale of inventory produced (in whole or in part) by the taxpayer within the United States and sold within a possession, or produced (in whole or in part) by a taxpayer in a possession and sold within the United States (Possession Production Sales). It also applies to determine the source of income derived from the purchase of personal property within a possession of the United States and its sale within the United States (Possession Purchase Sales). A taxpayer subject to this paragraph (f) must divide gross income from Section 863 Possession Sales using one of the methods described in either paragraph (f)(2)(i) of this section (in the case of Possession Production Sales) or paragraph (f)(3)(i) of this section (in the case of Possession Purchase Sales). Once a taxpayer has elected a method, the taxpayer must separately apply that method to the applicable category of Section 863 Possession Sales in the United States and to those in a possession. The source of gross income from each type of activity must then be determined under either paragraph (f)(2)(ii) or (3)(ii) of this section, as appropriate. The source of taxable income from Section 863 Possession Sales is determined under paragraph (f)(4) of this section. The taxpayer must apply the rules for computing gross and taxable income by aggregating all Section 863 Possession Sales to which a method in this section applies after separately applying that method to Section 863 Possession Sales in the United States and to Section 863 Possession Sales in a possession. This section does not apply to determine the source of a taxpayer's gross income derived from a sale of inventory purchased from a corporation that has an election in effect under section 936, if the taxpayer's income from sales of that inventory is taken into account to determine benefits under section 936 for the section 936 corporation. For rules to be applied to determine the source of such income, see §1.936–6(a)(5) Q&A 7a and 1.936–6(b)(1) Q&A 13.

(2) *Allocation or apportionment for Possession Production Sales*—(i) *Methods for determining the source of gross income for Possession Production Sales*—(A) *Possession 50/50 method.* Under the possession 50/50 method, gross income from Possession Production Sales is allocated between production activity and business sales activity as described in this paragraph (f)(2)(i)(A). Under the possession 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(A) of this section. The remaining one-half of such gross income will be considered income attributable to business sales activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(B) of this section.

(B) *IFP method.* In lieu of the possession 50/50 method, a taxpayer may elect the independent factory price (IFP) method. Under the IFP method, gross income from Possession Production Sales is allocated to production activity or sales activity using the IFP method, as described in paragraph (b)(2) of this section, if an IFP is fairly established under the rules of paragraph (b)(2) of this section. See paragraphs (f)(2)(ii)(A) and (C) of this section for rules for determining the source of gross income attributable to production activity and sales activity.

(C) *Books and records method.* A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, if it has received in advance the permission of the District Director having audit responsibility over its return. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) *Determination of source of gross income from production, business sales, and sales activity*—(A) *Gross income attributable to production activity.* The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, except that the term possession is substituted for foreign country wherever it appears.

(B) *Gross income attributable to business sales activity*—(*1*) *Source of gross income*. Gross income from the taxpayer's business sales activity is sourced in the possession in the same proportion that the amount of the taxpayer's business sales activity for the taxable year within the possession bears to the amount of the taxpayer's business sales activity for the taxable year both within the possession and outside the possession, with respect to Possession Production Sales. The remaining income is sourced in the United States.

(*2*) *Business sales activity.* For purposes of this paragraph (f)(2)(ii)(B), the

taxpayer's business sales activity is equal to the sum of—

(*i*) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Production Sales (other than amounts that are nondeductible under section 263A, interest, and research and development); and

(*ii*) Possession Production Sales for the taxable period.

(*3*) *Location of business sales activity.* For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(*i*) *Sales.* Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(*ii*) *Expenses.* Expenses will be attributed to a possession under the rules of §§1.861–8 through 1.861–14T.

(C) *Gross income attributable to sales activity.* The source of the taxpayer's income that is attributable to sales activity, as determined under the IFP method or the books and records method, will be determined under the provisions of paragraph (c)(2) of this section.

(3) *Allocation or apportionment for Possession Purchase Sales*—(i) *Methods for determining the source of gross income for Possession Purchase Sales*—(A) *Business activity method.* Gross income from Possession Purchase Sales is allocated in its entirety to the taxpayer's business activity, and is then apportioned between U.S. and possession sources under paragraph (f)(3)(ii) of this section.

(B) *Books and records method.* A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, subject to the conditions set forth in paragraph (b)(3) of this section. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) *Determination of source of gross income from business activity*—(A) *Source of gross income.* Gross income from the taxpayer's business activity is sourced in the possession in the same proportion that the amount of the taxpayer's business activity for the taxable year within the possession bears to the amount of the taxpayer's business activity for the taxable year both within the possession and outside the possession, with respect to Possession Purchase Sales. The remaining income is sourced in the United States.

(B) *Business activity.* For purposes of this paragraph (f)(3)(ii), the taxpayer's business activity is equal to the sum of—

(*1*) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Purchase Sales (other than amounts that are nondeductible under section 263A, interest, and research and development);

(*2*) Cost of goods sold attributable to Possession Purchase Sales during the taxable period; and

(*3*) Possession Purchase Sales for the taxable period.

(C) *Location of business activity.* For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(*1*) *Sales.* Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(*2*) *Cost of goods sold.* Payments for cost of goods sold will be properly attributable to gross receipts from sources within the possession only to the extent that the property purchased was manufactured, produced, grown, or extracted in the possession (within the meaning of section 954(d)(1)(A)).

(*3*) *Expenses.* Expenses will be attributed to a possession under the rules of §§1.861–8 through 1.861–14T.

(iii) *Examples.* The following examples illustrate the rules of paragraph (f)(3)(ii) of this section relating to the determination of source of gross income from business activity:

Example 1. (i) U.S. Co. purchases in a possession product X for $80 from A. A manufactures X in the possession. Without further production, U.S. Co. sells X in the United States for $100. Assume U.S. Co. has sales and administrative expenses in the possession of $10.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income from sales of X is allocated entirely to U.S. Co.'s business activity. Forty-seven dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases (i.e., cost of goods sold) ($80) plus possessions sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The remaining $53 is sourced in the United States.

Example 2. (i) Assume the same facts as in Example 1, except that A manufactures X outside the possession.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income is allocated entirely to U.S. Co.'s business activity. Five dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases ($0) plus possession sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The $80 purchase is not included in the numerator used to determine U.S. Co.'s business activity in the possession, since product X was not manufactured in the possession. The remaining $95 is sourced in the United States.

(4) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (f)(2) or (3) of this section, the taxpayer must properly allocate and apportion separately under §§1.861–8 through 1.861–14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Possession Sales determined separately under each method described in paragraph (f)(2) or (3) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Possession Sales under §1.861–17, the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of §1.861–17. Thus, in the case of gross income from Section 863 Possession Sales determined under the IFP method or books and records method, a taxpayer must apply the rules of §§1.861–8 through 1.861–14T to properly allocate or apportion amounts of expenses, losses and other deductions, allocated and apportioned to such gross income, between gross income from sources within and without the United States. However, in the case of gross income from Possession Production Sales determined under the possessions 50/50 method or gross income from Possession Purchase Sales computed under the business activity method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under those methods, except that the rules regarding the allocation and

apportionment of research and experimental expenditures in §1.861–17 shall apply to such expenditures of taxpayers using the 50/50 method.

(5) *Special rules for partnerships.* In applying the rules of this paragraph (f) to transactions involving partners and partnerships, the rules of paragraph (g) of this section apply.

(6) *Election and reporting rules*—(i) *Elections under paragraph (f)(2) or (3) of this section.* If a taxpayer does not elect one of the methods specified in paragraph (f)(2) or (3) of this section, the taxpayer must apply the possession 50/50 method in the case of Possession Production Sales or the business activity method in the case of Possession Purchase Sales. The taxpayer may elect to apply a method specified in either paragraph (f)(2) or (3) of this section by using the method on a timely filed original return (including extensions). Once a method has been used, that method must be used in later taxable years unless the Commissioner consents to a change. Permission to change methods from one year to another year will be granted unless the change would result in a substantial distortion of the source of the taxpayer's income.

(ii) *Disclosure on tax return.* A taxpayer who uses one of the methods described in paragraph (f)(2) or (3) of this section must fully explain in a statement attached to the tax return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.

* * * * *

(h) *Effective dates.* * * * However, the rules of paragraph (f) of this section apply to taxable years beginning on or after November 13, 1998.

Par. 3. In §1.936–6, paragraph (a)(5) Q&A 7a is added to read as follows:

§1.936–6 Intangible property income when an election out is made: Cost sharing and profit split options; covered intangibles.

* * * * *

(a) * * *

(5) * * *

Q.7a: What is the source of the taxpayer's gross income derived from a sale in the United States of a possession product purchased by the taxpayer (or an affiliate) from a corporation that has an election in effect under section 936, if the income from such sale is taken into account to determine benefits under cost sharing for the section 936 corporation? Is the result different if the taxpayer (or an affiliate) derives gross income from a sale in the United States of an integrated product incorporating a possession product purchased by the taxpayer (or an affiliate) from the section 936 corporation, if the taxpayer (or an affiliate) processes the possession product or an excluded component in the United States?

A.7a: Under either scenario, the income is U.S. source, without regard to whether the possession product is a component, end-product, or integrated product. Section 863 does not apply in determining the source of the taxpayer's income. This Q&A 7a is applicable for taxable years beginning on or after November 13, 1998.

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In §602.101, paragraph (c) is amended in the table by revising the entry for 1.863–3 to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.863–3	1545–1476 1545–1556
* * * * *	

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

Approved September 18, 1998.

Donald C. Lubick,
Assistant Secretary of the Treasury for Tax Policy.

(Filed by the Office of the Federal Register on October 13, 1998, at 8:45 a.m., and published in the issue of the Federal Register for October 14, 1998, 63 F.R. 55020)

Roth IRA Guidance

Notice 98–50

PURPOSE

This notice responds to questions that have arisen regarding whether a taxpayer who has converted an amount from a traditional IRA to a Roth IRA may not only transfer the amount back to a traditional IRA in a recharacterization but also subsequently "reconvert" that amount from the traditional IRA to a Roth IRA.

BACKGROUND

Section 408A of the Internal Revenue Code (the "Code"), which was added by § 302 of the Taxpayer Relief Act of 1997, Pub. L. 105–34, establishes the Roth IRA as a new type of individual retirement plan, effective for taxable years beginning on or after January 1, 1998. The provisions of § 408A were amended by the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105–206. On September 3, 1998, proposed regulations relating to Roth IRAs, §§ 1.408A–1 through 1.408A–9, were published in the Federal Register (63 F.R. 46937). This notice incorporates definitions and terms used in those proposed regulations.

Section 408A(d)(3) of the Code and § 1.408A–4 of the proposed regulations prescribe rules for the conversion of an amount from a traditional IRA to a Roth IRA. Any amount converted from a traditional IRA to a Roth IRA is treated as distributed from the traditional IRA and rolled over to the Roth IRA and is generally includible in gross income for the year in which the amount is distributed or transferred from the traditional IRA (subject to a "4-year spread" for 1998 conversions, unless the taxpayer elects otherwise).

Section 408A(d)(6) of the Code and § 1.408A–5 of the proposed regulations prescribe rules for "recharacterizations" of IRA contributions, including Roth IRA conversion contributions. Section 408A(d)(6) provides that, except as otherwise provided by the Secretary of the Treasury, an IRA contribution that is transferred to another IRA in a trustee-to-trustee transfer on or before the date prescribed by law for filing the taxpayer's Federal income tax return, including extensions, (the "due date") for the taxable year of the contribution is treated as made to the transferee IRA and not the transferor IRA. The proposed regulations interpret § 408A(d)(6) to make its application elective by the taxpayer, permit the taxpayer to recharacterize most types of IRA contributions, and permit the taxpayer to recharacterize all or any portion of an IRA contribution.

TREATMENT OF RECONVERSIONS

The question has arisen whether a taxpayer who has converted an amount from a traditional IRA to a Roth IRA may not only transfer the amount back to a traditional IRA in a recharacterization but also subsequently "reconvert" that amount from the traditional IRA to a Roth IRA. The proposed regulations do not specifically address this question, and the Service and Treasury are considering whether final regulations should permit reconversions under any circumstances. However, effective as of November 1, 1998, the interim rules set forth below will apply for 1998 and 1999. Any future guidance that either prohibits reconversions or imposes conditions on reconversions more restrictive than those imposed under this notice will not apply to reconversions completed before issuance of that guidance.

If a taxpayer converts (or reconverts) an amount, transfers that amount back to a traditional IRA by means of a recharacterization, and reconverts that amount in a transaction for which the taxpayer is not eligible under the interim rules set forth in this notice, the reconversion will be deemed an "excess reconversion." However, any reconversions that a taxpayer has made before November 1, 1998, will not be treated as excess reconversions and will not be taken into account in determining whether any later reconversion is an excess reconversion.

A taxpayer who converts an amount from a traditional IRA to a Roth IRA during 1998 and then transfers that amount back to a traditional IRA by means of a recharacterization is eligible to reconvert that amount to a Roth IRA once (but no more than once) on or after November 1, 1998, and on or before December 31, 1998; the taxpayer also is eligible to reconvert that amount once (but no more than once) during 1999. (Any conversion of that amount during 1999 would constitute a reconversion because the taxpayer previously converted that amount during 1998.) This rule applies without regard to whether the taxpayer's initial conversion or recharacterization of the amount occurs before, on, or after November 1, 1998, and (as indicated above) even if the taxpayer has made one or more reconversions before November 1, 1998.

A taxpayer who converts an amount from a traditional IRA to a Roth IRA during 1999 that has not been converted previously and then transfers that amount back to a traditional IRA by means of a recharacterization is eligible to reconvert that amount to a Roth IRA once (but no more than once) on or before December 31, 1999. In determining whether a taxpayer has made a previous conversion for purposes of these interim rules, a failed conversion, as described in proposed regulations § 1.408A–4, Q&A–3 (that is, an attempted conversion for which the taxpayer is not eligible for reasons set forth in proposed regulations § 1.408A–4), will not be treated as a conversion.

Any excess reconversion of an amount during 1998 or 1999 will not change the taxpayer's taxable conversion amount (as defined in proposed regulations § 1.408A–8, Q&A–1(b)(7)). Instead, the excess reconversion and the last preceding recharacterization will not be taken into account for purposes of determining the taxpayer's taxable conversion amount, and the taxpayer's taxable conversion amount will be based on the last reconversion that was not an excess reconversion (unless, after the excess reconversion, the amount is transferred back to a traditional IRA by means of a recharacterization). An excess reconversion will otherwise be treated as a valid reconversion.

Any conversion, recharacterization, or reconversion of an amount under this notice must satisfy the provisions of § 408A and the proposed regulations. For example, a taxpayer making a conversion or reconversion must satisfy the $100,000

modified AGI limitation of § 408A(c)-(3)(B)(i) and proposed regulations § 1.408A–4, Q&A-2, and a taxpayer transferring a contribution from one IRA to another IRA by means of a recharacterization must make the transfer on or before the due date for the taxable year of the contribution, as required by § 408A(d)(6) and proposed regulations § 1.408A–5, Q&A–1. In determining the portion of any amount held in a Roth IRA or a traditional IRA that a taxpayer is not eligible to reconvert under the interim rules set forth in this notice, any amount previously converted (or reconverted) is adjusted for subsequent net gains or losses thereon.

Example 1. On May 1, 1998, T converted an amount in a traditional IRA (Traditional IRA 1) to a Roth IRA (Roth IRA 1). T did not contribute any other amount to Roth IRA 1. On October 15, 1998, T transferred the amount in Roth IRA 1 to a traditional IRA (Traditional IRA 2) by means of a recharacterization. T is eligible to reconvert the amount in Traditional IRA 2 to a Roth IRA once (but no more than once) at any time on or after November 1, 1998, and on or before December 31, 1998. Any additional reconversion during 1998 would be an excess reconversion. This result would not be different if the recharacterization had occurred on or after November 1, 1998, instead of before November 1, 1998.

Example 2. The facts are the same as in *Example 1*, except that, on November 25, 1998, T reconverts the amount in Traditional IRA 2 to a Roth IRA (Roth IRA 2). After that reconversion, T may transfer the amount from Roth IRA 2 back to a traditional IRA by means of a recharacterization, but any subsequent reconversion of that amount to a Roth IRA before January 1, 1999, would be an excess reconversion. If T does transfer the amount from Roth IRA 2 back to a traditional IRA by means of a recharacterization, T is eligible to reconvert that amount once (but no more than once) during 1999. Any additional reconversion of that amount during 1999 would be an excess reconversion.

Example 3. The facts are the same as in *Example 2*, except that, on December 4, 1998, T transfers the amount from Roth IRA 2 back to a traditional IRA (Traditional IRA 3) by means of a recharacterization. If T does not reconvert that amount to a Roth IRA on or before December 31, 1998, T cannot use the 4-year spread available for 1998 conversions.

Example 4. The facts are the same as in *Example 3.* The value of the amount converted on May 1, 1998, was $X, and the value of the amount converted on November 25, 1998, was $Y. On December 8, 1998, T reconverts the amount in Traditional IRA 3 (which then has a value of $Z) to a Roth IRA (Roth IRA 3). Under the interim rules set forth in this notice, T is not eligible to make the December 8, 1998, reconversion, and that excess reconversion will not be taken into account for purposes of determining T's taxable conversion amount (although it is otherwise treated as a valid conversion). Instead, T's taxable conversion amount will be based on T's November 25, 1998, reconversion. Therefore, T's taxable conversion amount will be $Y. Because it is a 1998 conversion, the November 25, 1998, reconversion is eligible for the 4-year spread (unless T again transfers the amount from Roth IRA 3 to a traditional IRA by means of a recharacterization).

Example 5. The facts are the same as in *Example 2*, except that T's modified AGI for 1998 was $110,000. Therefore, T was not eligible to convert an amount from a traditional IRA to a Roth IRA in 1998, and T's attempted conversion (on May 1, 1998) and reconversion (on November 25, 1998) are failed conversions, as described in proposed regulations § 1.408A–4, Q&A–3. Therefore, if T transfers the amount of the failed conversion in Roth IRA 2 back to a traditional IRA by means of a recharacterization and converts that amount from the traditional IRA to a Roth IRA during 1999, T will be eligible to reconvert that amount once (but no more than once) on or before December 31, 1999. Any additional reconversion of that amount during 1999 would be an excess reconversion.

Example 6. On November 5, 1998, R converts an amount in a traditional IRA (Traditional IRA 1) to a Roth IRA (Roth IRA 1). On November 25, 1998, R transfers the amount in Roth IRA 1 back to a traditional IRA (Traditional IRA 2) by means of a recharacterization. R is then eligible to reconvert the amount in Traditional IRA 2 to a Roth IRA at any time on or before December 31, 1998. After that reconversion, R may transfer the amount back to a traditional IRA by means of a recharacterization, but any subsequent reconversion of that amount to a Roth IRA before January 1, 1999, would be an excess reconversion. If R does transfer the amount back to a traditional IRA by means of a recharacterization (whether before or after the end of 1998), R will be eligible to reconvert that amount once (but no more than once) during 1999. Any additional reconversion of that amount during 1999 would be an excess reconversion.

Example 7. On January 5, 1999, S converts an amount in a traditional IRA (Traditional IRA 1) to a Roth IRA (Roth IRA 1). S had not previously converted that amount. On February 17, 1999, S transfers the amount in Roth IRA 1 back to a traditional IRA (Traditional IRA 2) by means of a recharacterization. After the recharacterization, S is eligible to reconvert the amount in Traditional IRA 2 once (but no more than once) at any time on or before December 31, 1999. Any additional reconversion of that amount during 1999 would be an excess reconversion.

This notice is intended to clarify and supplement the guidance provided in the proposed regulations under § 408A and may be relied upon as if it were incorporated in those regulations. In accordance with the procedures for submitting comments on the proposed regulations, interested parties are invited to submit comments on whether final regulations should permit reconversions (and, if so, under what circumstances and conditions). Possible approaches to reconversions in final regulations might include providing that a taxpayer is not eligible to reconvert an amount before the end of the taxable year in which the amount was first converted (or the due date for that taxable year) or that a taxpayer who transfers a converted amount back to a traditional IRA in a recharacterization must wait until the passage of a fixed number of days (e.g., 30 or 60 days) before reconverting. Additionally, such approaches might include providing that an excess reconversion would be treated as a failed conversion that would be subject to the consequences described in proposed regulations § 1.408A–4, Q&A–3, and that could be remedied as described therein.

DRAFTING INFORMATION

The principal authors of this notice are Roger Kuehnle of the Employee Plans Division and Cathy A. Vohs of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the Internal Revenue Service and the Treasury Department participated in its development. For further information regarding this notice, please contact the Employee Plans Division's taxpayer assistance telephone service at (202) 622-6074/6075 (not toll-free numbers), between the hours of 1:30 and 3:30 p.m. Eastern Time, Monday through Thursday, or Ms. Vohs at (202) 622-6030 (also not toll-free).

Weighted Average Interest Rate Update

Notice 98–51

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for September 1998 is 5.20 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 106% Permissible Range	90% to 110% Permissible Range
October	1998	6.40	5.76 to 6.79	5.76 to 7.05

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans Division. For further information regarding this notice, call (202) 622-6076 between 2:30 and 3:30 p.m. Eastern time (not a toll-free number). Mr. Newman's number is (202) 622-8458 (also not a toll-free number).

Part IV. Items of General Interest

Announcement 98–95

Revisions to Form 8857

Purpose

The purpose of this announcement is to request public comments on the revised Form 8857, Request for Innocent Spouse Relief (And Allocation of Liability and Equitable Relief). Form 8857 is being revised to reflect section 3201 of the IRS Restructuring and Reform Act of 1998.

Note: *The revised Form 8857 in this announcement is subject to change and OMB approval before final release.*

Revisions to Form 8857

The revisions include the following:

- The requirement that filers need to have over $500 of additional tax due in order to request relief is eliminated.
- Procedures are provided for requesting innocent spouse relief, allocation of liability, and equitable relief.
- Explanations of the law changes and types of relief are added to the instructions.

Benefits of the revisions

The revised Form 8857 will:

- Help filers become aware of the new tax law.
- Provide filers a means to request the various types of relief.
- Help filers by providing simple explanations of the new tax law and guidance for completing the form.
- Allow the IRS to improve control and processing of the requests by highlighting the Cincinnati Service Center filing address.

Comments requested

The IRS would like to receive comments on the proposed revisions to Form 8857 from interested parties by November 30, 1998. Send written comments to:

Chairman, Tax Forms Coordinating Committee
Internal Revenue Service, OP:FS:FP, Room 5577
1111 Constitution Avenue, NW
Washington, D.C. 20224

Alternatively, you may send comments to the Chairman, TFCC, by fax at (202) 622-5025, or e-mail to tfpmail@publish.no.irs.gov

After the end of the comment period, the IRS will evaluate the documents received and announce the final changes to Form 8857. Although we will not be able to respond to each comment, we will carefully consider all of them.

Form **8857**
(Rev. December 1998)
Department of the Treasury
Internal Revenue Service

Request for Innocent Spouse Relief

(And Allocation of Liability and Equitable Relief)

▶ **Do not file with your tax return.** ▶ **See instructions.**

OMB No. 1545-1596

Your name | Your social security number

Your current home address (number and street). If a P.O. box, see instructions. | Apt. no.

City, town or post office, state, and ZIP code. If a foreign address, see instructions | Daytime phone no. (optional) ( )

Before you begin, you need to understand the following terms. See instructions for descriptions.

- Allocation of Liability
- Innocent Spouse Relief
- Equitable Relief
- Joint and Several Liability
- Understatement of Tax
- Underpayment of Tax
- Erroneous Items

TIP *The IRS can help you with your request. If you are working with an IRS employee, you can ask that employee or you can call 1-800-829-1040.*

1 Enter the year for which you are requesting relief from liability of tax . . . . . ▶

2 Information about your spouse (or former spouse) to whom you were married at the end of the year on line 1.

Name | Social security number

Current home address (number and street). If a P.O. box, see instructions. | Apt. no.

City, town or post office, state, and ZIP code. If a foreign address, see instructions. | Daytime phone no. (if known) ( )

3 Allocation of Liability

You may be relieved of liability for the portion of an understatement of tax that is allocable to your spouse (or former spouse) if you and your spouse (or former spouse):

- Are no longer married,
- Are legally separated, or
- Have lived apart at all times during the 12-month period prior to the date you file this form.

To elect allocation of liability, attach a statement as explained in the instructions and check here . . . ▶ ☐

4 Innocent Spouse Relief

TIP *You may not need to request innocent spouse relief if you qualify for allocation of liability. However, you may still request innocent spouse relief if you wish.*

You may be allowed relief for an understatement of tax due to erroneous items of your spouse (or former spouse). To request innocent spouse relief, attach a statement as explained in the instructions and check here . . ▶ ☐

5 Equitable Relief

If you do not qualify for relief under **3** or **4** above, you may request equitable relief. If you want to request equitable relief, attach a statement as explained in the instructions and check here . . . . . ▶ ☐

Where To File: Generally, send this form to: **Internal Revenue Service Center, Cincinnati, OH 45999-0857.** But if you are meeting with an IRS employee or you received an IRS notice of deficiency, see page 2.

Under penalties of perjury, I declare that I have examined this form and any accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Sign Here Keep a copy of this form for your records. Your signature ▶ | Date

Paid Preparer's Use Only Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's social security no.

Firm's name (or yours if self-employed) and address ▶ | EIN | ZIP code

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 24647V Form **8857** (Rev. 12-98)

Printed on recycled paper

General Instructions

A Change To Note

The Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 simplified innocent spouse relief. You can now request innocent spouse relief for an understatement of tax no matter how small the amount. If you are divorced, separated, or no longer living with your spouse, you may now elect to allocate liability for an understatement of tax on a joint return between you and your spouse (or former spouse). Also, the IRS will consider your request for equitable relief in situations where it would be unfair to hold you liable for tax that should be paid only by your spouse (or former spouse).

The new law applies to any tax liability arising after July 22, 1998, or any tax liability that was unpaid as of that date. For relief of liability for amounts that were paid as of that date, check the box on line 4 and attach the requested statement (see **Pub. 971,** Innocent Spouse Relief, for limits that may apply).

Purpose of Form

Use Form 8857 to request relief from liability for tax you owe, plus related penalties and interest, that you believe should be paid only by your spouse (or former spouse). You generally must have filed a joint return for the year for which you owe tax (but see **Community Property Laws** on page 3). If you owe tax for more than 1 year, file a separate Form 8857 for each year. The IRS will evaluate your request and tell you if you qualify.

You can request one or more of these three types of relief:

- Innocent spouse relief (see page 3),
- Allocation of liability (see page 3), or
- Equitable relief (see page 4).

Additional information. See Pub. 971 for more details.

When and Where To File

When to file. Generally, you should file Form 8857 as soon as you become aware of an unpaid tax liability that you believe should be paid only by your spouse (or former spouse). The following are some of the ways you may become aware of such a liability.

- The tax return is examined by the IRS.
- You receive an IRS notice.

You must file Form 8857 no later than 2 years after the first IRS attempt to collect the tax. However, you may file it any time up to 2 years after the first IRS attempt to collect the tax that occurs after July 22, 1998.

Where to file. Do not file Form 8857 with your tax return. Instead, see below.

IF . . .	THEN file Form 8857 with . . .
You are meeting with an IRS employee for an examination, examination appeal, or collection,	That IRS employee.
You received an IRS notice of deficiency, and the 90-day period specified in the notice has not expired.*	The IRS employee named in the notice. Attach a copy of the notice.
None of the situations above apply to you,	**Internal Revenue Service Center Cincinnati, OH 45999-0857**

*Before the end of the 90-day period, you should file a petition with the Tax Court, as explained in the notice. By doing so, you preserve your rights if the IRS is unable to properly consider your request before the end of the 90-day period. Include the information that supports your position, including when and why you filed Form 8857, in your petition to the Tax Court. The time for filing with the Tax Court is **not** extended while the IRS is considering your request.

Tax Court Review of Request

You may petition (ask) the Tax Court to review your request for innocent spouse relief or your election to allocate liability if:

- The IRS sends you a determination notice denying, in whole or in part, your request for or election of relief, **or**
- You have not received a determination notice from the IRS within 6 months from the date you filed Form 8857.

You may petition the Tax Court to review your request no later than the end of the 90-day period that begins on the date the IRS mails you a determination notice. See Pub. 971 for details on petitioning the Tax Court to review your request.

Joint and Several Liability

Generally, joint and several liability applies to all joint returns. This means that both you and your spouse (or former spouse) are liable for any tax shown on a joint return plus any **understatement of tax** (defined below) that may become due later. This is true even if a divorce decree states that your former spouse will be responsible for any amounts due on previously filed joint returns. Form 8857 allows you to request that joint and several liability not apply to part or all of any unpaid tax.

Understatement of Tax

An understatement of tax, or deficiency, is generally the difference between the total amount of tax that should have been shown on the return and the amount that actually was shown on the return. This amount can be reduced by an abatement, credit, refund, or other payment.

Example. You and your spouse (or former spouse) file a joint return showing $5,000 of tax, which was fully paid. The return is later audited by the IRS. The IRS finds $10,000 of income that your spouse earned but did not report on the tax return. With the additional income, the total tax becomes $6,500. You and your spouse are both liable for the $1,500 understatement of tax. You could request innocent spouse relief or elect allocation of liability for the understatement of tax. If you are not eligible for either type of relief, you could request equitable relief.

Underpayment of Tax

An underpayment is tax that is properly shown on the return, but has not been paid.

Example. You filed a joint return that properly reflects your income and deductions, but showed an unpaid balance due of $5,000. You and your spouse were getting divorced. You gave your spouse $2,500 and your spouse promised to pay the full $5,000, but did not. You would not be eligible for innocent spouse relief or allocation of liability because there is no understatement of tax. However, you may request equitable relief for the underpayment of tax.

Community Property Laws

You must generally follow community property laws when filing a tax return if you are married and live in a community property state. Community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Generally, community property laws require you to allocate community income and expenses equally between both spouses. However, community property laws are not taken into account in determining whether an item belongs to you or to your spouse (or former spouse) for purposes of requesting any relief from liability.

Note: *If you were married and filed a separate return in a community property state and are now liable for an underpayment or understatement of tax you believe should be paid only by your spouse (or former spouse), you may request equitable relief.*

Specific Instructions

Your Current Home Address

P.O. box. Enter the box number instead of your street address **only** if the post office does not deliver mail to your home.

Foreign address. Enter the information in the following order: city, province or state, and country. Follow the country's practice for entering the postal code. Please do not abbreviate the country name.

Line 2—Information About Your Spouse (or Former Spouse)

Enter the current name and social security number (SSN) of the person to whom you were married at the end of the year listed on line 1. If the name of your spouse (or former spouse) shown on that year's tax return is different from the current name, enter it in parentheses after the current name. For example: Jane Maple (formerly Jane Oak). Enter the current address and phone number if you know it.

P.O. box. Enter the box number instead of the street address **only** if you do not know the street address.

Foreign address. Enter the information as explained above.

Line 3—Allocation of Liability

If you filed a joint return for the year entered on line 1, you may be able to allocate liability for any understatement of tax on that return between you and your spouse (or former spouse). Generally, you can elect to do so if you and that person:

- Are no longer married,
- Are legally separated, or
- Have lived apart at all times during the 12-month period prior to the date you file Form 8857.

Note: *A widow or widower is considered no longer married.*

You must show which items that caused the understatement are allocable to you and which are allocable to your spouse (or former spouse).

Exception. If, at the time you signed the joint return, you knew about any item not allocable to you that resulted in part or all of the understatement, then your election will not apply to that part of the understatement.

Electing Allocation of Liability

Check the box on line 3 and attach a statement to Form 8857. Show the total amount of the understatement of tax for which you are liable. For each item that resulted in an understatement of tax, explain whether the item is attributable to you, your spouse (or former spouse), or both of you. Generally, allocate the items as if you had filed separate returns. You may wish to complete, as worksheets, separate tax returns for yourself and your spouse (or former spouse) to show the allocation. For example, unreported income earned by your spouse (or former spouse), plus any related self-employment tax, would be allocated to that person. An overstated deduction of home mortgage interest on a home you owned jointly that was paid from a joint checking account would generally be allocated equally between both of you. See Pub. 971 for more details.

Line 4—Innocent Spouse Relief

TIP *If you qualify for allocation of liability, you may not need to request innocent spouse relief. The amount of relief allowed by electing allocation of liability may be equal to or greater than the amount allowed by requesting innocent spouse relief. However, you may still request innocent spouse relief if you wish.*

You may be allowed innocent spouse relief if:

- You filed a joint return for the year entered on line 1,
- There is an understatement of tax on that return that is due to erroneous items of your spouse (or former spouse),
- You can show that when you signed the return you did not know and had no reason to know that the understatement of tax existed (or the extent of the understatement), and
- Taking into account all the facts and circumstances, it would be unfair to hold you liable for the understatement of tax.

Erroneous Items

Any income, deduction, or credit is an erroneous item if:

- It is omitted from or incorrectly reported on the joint return,
- It is attributable to your spouse (or former spouse),
- It results in an understatement of tax, **and**
- You either did not know and had no reason to know about the understatement or the extent of it (see **Partial Innocent Spouse Relief** below).

Erroneous items can include the following:

- Income received by your spouse that is not reported on the joint return, or
- A deduction or credit incorrectly claimed on the joint return by your spouse.

Partial Innocent Spouse Relief

If you knew about any of the erroneous items, but not the full extent of the item(s), you may be allowed relief for part of the understatement. Explain in the statement you attach to Form 8857 how much you knew and why you did not know, and had no reason to know, the full extent of the item(s).

Requesting Innocent Spouse Relief

To request innocent spouse relief, check the box on line 4 and attach a statement to Form 8857 explaining why you believe you qualify. The contents of the statement will vary depending on your circumstances, but should include the following:

- The amount and a detailed description of each erroneous item, including the extent, if any, to which you knew about it and why you had no reason to know about the item or know the extent of the item,
- The amount of the understatement of tax for which you are liable and are seeking relief, and
- Why you believe it would be unfair to hold you liable for the understatement of tax.

Line 5—Equitable Relief

You may be allowed equitable relief if, taking into account all the facts and circumstances, it would be unfair to hold you liable for any understatement or underpayment of tax that should be paid only by your spouse (or former spouse).

You can only be allowed equitable relief for part or all of any liability that does not qualify for either allocation of liability or innocent spouse relief. You should request allocation of liability or innocent spouse relief first, unless you are sure you are not eligible. The IRS cannot consider requests for equitable relief until it has been determined that innocent spouse relief and allocation of liability do not apply.

Requesting Equitable Relief

Attach an explanation of why you believe it would be unfair to hold you liable for the tax instead of your spouse (or former spouse).

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. We need it to determine the amount of liability, if any, of which you may be relieved. Internal Revenue Code section 6015 allows relief of liability. If you request or elect relief of liability, you must give us the information requested on this form. Code section 6109 requires you to provide your social security number. Routine uses of this information include giving it to the Department of Justice for civil and criminal litigation, and to cities, states, and the District of Columbia for use in administering their tax laws. If you do not provide all the information in a timely manner, we may not be able to process your request or election.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Code section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Learning about the law or the form,** 17 min.; **Preparing the form,** 17 min.; and **Copying, assembling, and sending the form to the IRS,** 20 min.

If you have comments concerning the accuracy of this time estimate or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **DO NOT** send the form to this address. Instead, see **When and Where To File** on page 2.

Conversion to the Euro; Correction

Announcement 98–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to temporary regulations.

SUMMARY: This document contains a correction to Treasury Decision 8776, which was published in the **Federal Register** on Wednesday, July 29, 1998 (63 F.R. 40366 [1998–33 I.R.B. 6]) relating to U.S. taxpayers operating, investing or otherwise conducting business in the currencies of certain European countries that are replacing their national currencies with a single, multinational currency called the euro.

DATES: This correction is effective July 29, 1998.

FOR FURTHER INFORMATION CONTACT: Howard Weiner, (202) 622-3870 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations that are the subject of this correction are under section 1001 of the Internal Revenue Code.

Need for Correction

As published, TD 8776 contains an error which may prove to be misleading and is in need of clarification.

Correction of Publication

Accordingly, the publication of the temporary regulations (TD 8776), which was the subject of FR Doc. 98–20023, is corrected as follows:

§1.985–8T [Corrected]

On page 40369, column 2, §1.985–8T(c)(3)(iv)(B), third line from the top of the column, the language "year of change which includes the" is corrected to read "year ending immediately prior to the year of change which includes the".

Cynthia E. Grigsby,
Chief, Regulations Unit,
Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on October 14, 1998, 8:45 a.m., and published in the issue of the Federal Register for October 15, 1998, 63 F.R. 55333)

Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions; Correction

Announcement 98–97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to notice of proposed rulemaking.

SUMMARY: This document contains a correction to REG–245256–94, which was published in the **Federal Register** on Tuesday, August 4, 1998 (63 F.R. 41486 [1998–34 I.R.B. 9]), relating to the excise taxes on excess benefit transactions.

FOR FURTHER INFORMATION CONTACT: Phyllis D. Haney, (202) 622-4290 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The notice of proposed rulemaking that is the subject of this correction is under section 4958 of the Internal Revenue Code.

Need for Correction

As published, REG–246256–96 contains an error which may prove to be misleading and is in need of clarification.

Correction of Publication

Accordingly, the publication of the notice of proposed rulemaking (REG–246256–96), which is the subject of FR Doc. 98–20419, is corrected as follows:

§53.4958–4 [Corrected]

On page 41502, column 1, §53.4958–4(b)(3)(iii), *Example 2,* ninth line from the bottom of the paragraph, the language "determination of whether N's compensation" is corrected to read "determination of whether K's compensation".

Cynthia E. Grigsby,
Chief, Regulations Unit,
Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on October 6, 1998, 8:45 a.m., and published in the issue of the Federal Register for October 7, 1998, 63 F.R. 53862)

Deletions From Cumulative List of Organizations Contributions to Which Are Deductible Under Section 170 of the Code

Announcement 98–98

The names of organizations that no longer qualify as organizations described in section 170(c)(2) of the Internal Revenue Code of 1986 are listed below.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on November 2, 1998, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual who was responsible, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Crossreach of the Holy Cross Society,
Lake Orion, MI
Flynn Home for Alcoholic Addiction,
Inc., Portsmouth, VA
Senior Housing, Inc.,
Hampton, VA
Senior Meals, Inc.,
Hampton, VA

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C.—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedral Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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Key to Abbreviations:

RR	Revenue Ruling
RP	Revenue Procedure
TD	Treasury Decision
CD	Court Decision
PL	Public Law
EO	Executive Order
DO	Delegation Order
TDO	Treasury Department Order
TC	Tax Convention
SPR	Statement of Procedural Rules
PTE	Prohibited Transaction Exemption

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